SEP 1 4 1982

Y 1.1/8:97-786

UNION CALENDAR 479

97th Congress, 2nd Session ---------- House Rept. 97-786

COMPLETED

ORIGINAL

33

House of Representatives

MONETARY POLICY FOR 1982
EIGHTH REPORT

Together with MINORITY and DISSENTING Views

BY THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

AUGUST 20, 1982—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed.

U.S. GOVERNMENT PRINTING OFFICE

89-006 O WASHINGTON : 1982

BEST DOCUMENT AVAILABLE

BLANK PAGE

LETTER OF SUBMITTAL

U.S. HOUSE OF REPRESENTATIVES,
Washington, D.C., August 20, 1982.

Hon. THOMAS P. O'NEILL, JR.,
Speaker of the House of Representatives,
Washington, D.C.

DEAR MR. SPEAKER: Submitted herewith is the Eighth Report of the Committee on Banking, Finance and Urban Affairs pursuant to Public Law 95-523, the Full Employment and Balanced Growth Act of 1978. The monetary policy reporting procedure specified in the Act is in large part the result of the efforts of two Members of this Committee, who this year will retire from the House of Representatives. The two Members, Congressmen Henry Reuss and William Stanton, the Ranking Majority and Minority Members of the Committee, deserve our highest expressions of appreciation for their years of dedicated service in behalf of the economic well-being of all Americans. Their experience and judgment will be sorely missed by the Committee.

Sincerely,

FERNAND J. ST GERMAIN,
Chairman.

BLAKE PAGE

BEST DOCUMENT AVAILABLE

Union Calendar No. 479

97TH CONGRESS, 2d Session | HOUSE OF REPRESENTATIVES | REPORT No. 97-786

MONETARY POLICY FOR 1982

AUGUST 20, 1982.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. ST GERMAIN, from the Committee on Banking, Finance and Urban Affairs, submitted the following

EIGHTH REPORT

ON THE CONDUCT OF MONETARY POLICY

INTRODUCTION

The eighth monetary-policy hearing by the Committee on Banking, Finance and Urban Affairs, called for by the Full Employment and Balanced Growth Act, was held on July 21, 1982. Like the monetary policy hearings which preceded it in February and March, 1982, and July 1981, the Committee's concern was with the widespread evidence of the continuing failure of Reaganonomics. Unemployment, business bankruptcies, and economic hardship were increasing then and are now at near record levels amid signs of increasing financial stress. Committee Chairman Fernand J. St Germain said the hearing had a "deja vu quality".

In the months preceding the hearing and Federal Reserve Chairman Paul Volcker's presentation of the Midyear Policy Report to Congress, business bankruptcies were occurring at an annual rate of 80 per ten thousand firms. Over 900 businesses went bankrupt in the first two weeks of July alone. The percentage of loans at national banks with principle and interest past due had risen from 4.3% in March 1981 to 4.9% in March 1982. Announcements of substantial losses by major money-center and regional banks were becoming weekly occurrences. To keep financial shocks like the Drysdale and Penn Square failures from precipitating more profound problems, the Federal Reserve eased its monetary policy, allowing interest rates to fall moderately, and it reduced its own Discount Window interest rate only days before the hearing as a

89-006 O

BEST DOCUMENT AVAILABLE

signal to money markets of its intentions. At the hearing, Federal Reserve Chairman Volcker expressed Federal Reserve intentions in terms of seeking monetary growth "around the top" of the target ranges it had set last February.

Whether the Federal Reserve's recent actions can halt the continuing downward slide of the American economy is not clear. The combined effects of the Reagan Administration's tax, spending and monetary policies may have already wrought such economic harm that a modified monetary policy alone may not be sufficient. It certainly will not be enough to bring about the vigorous recovery that Administration officials just a few months ago predicted would occur.

ECONOMIC BACKGROUND

UNEMPLOYMENT

Unemployment for the fourth straight month has afflicted more that 10 million Americans, with the July unemployment rate of 9.8% being the highest level since 1941. Total employment after a small increase in May fell below 100 million in June and July. Hardest hit are teenagers (24.1% unemployment rate in July), Hispanics (13.9%), and blacks (18.5), with close to 60% of black male teenagers being unemployed. Adult male workers, the primary breadwinners in the majority of families, are being hit with an 8.8% unemployment rate. One out of every five workers in the past year has been without a job at one time or another.

BUSINESS CONDITIONS

Unemployment is not the only sign of economic distress. American industry has been operating at 72 percent of capacity, business bankruptcies are occurring at the highest rate since the Great Depression. The farm economy is extremely depressed, with farmers' cash receipts in constant dollars at the lowest level since 1968 and farmers' debt burdens and interest costs very heavy. Home building remains at depression levels. Housing starts fell back in June to a rate below one million a year after signs of improvement in May. Domestic auto sales remain at an average rate below 6 million cars per year for the first half of 1982, reaching a low annual rate of 4.6 million cars in June; if this continues, 1982 would go down as the worst year for domestic auto sales in the last two decades.

BUSINESS FINANCE

Business balance sheets and corporate liquidity are more fragile than at any other time in the postwar period. Faced with the record high long-term interest rates, businesses in this recession have been unable to restructure debts into longer maturities, and instead have borrowed a larger and larger amount of short-term credit simply to keep going. At best, this means that business investment will be small and late in coming in any recovery. At worst, the precarious liquidity position means that many companies will face bankruptcy if interest rates rise or credit is tightened. Already dozens of major corporations, including Braniff Air-

BEST DOCUMENT AVAILABLE

lines, the Wickes Companies, Saxon Industries and AM International have been forced into bankruptcy. If credit conditions worsen because of rising Federal deficits and if monetary growth is inflexibly held to outdated targets, the results could be no recovery, new waves of bankruptcies, and still more unemployment.

INFLATION

The consumer price index grew at an annual rate of 4.1 percent and the GNP price deflator at a 5.3 rate, in the second quarter of 1982. This improvement, however, has been offset by a recent return to double-digit annual rates of increase in the CPI, which weaken the prospects for further abatement of inflation. In any case, the progress against inflation, while welcome, is tainted by the heavy costs in unemployment, bankruptcies and lost output from this administration's anti-inflation policies.

INTEREST RATES

Mortgage and long-term bond rates are critical determinants of American investment and economic growth. However, they have remained at prohibitively high levels, even though short-term interest rates have moderated in recent weeks, registering about a three-to-four percentage point decline from a year ago. As long as long-term rates remain high, the chances for a sustained recovery will be slim.

Discussion and Findings

In past reports, this Committee has commented on the conduct of monetary policy as follows:

February, 1981—

The Committee, taking into account current economic conditions, now adds to this prescription for a steady monetary policy, the view that there should be no abrupt decline in monetary growth. No attempt should be made to rapidly squeeze inflation from our economy. The costs in unemployment would be intolerable.

July, 1981—

The Federal Reserve Board, with full Administration support, has erred in lowering its target ranges for M1-B growth in 1981 and 1982. It has erred severely in limiting M1-B growth to a 0.7 percent annual rate through June of 1981. The Federal Reserve Board should immediately bring M1-B into the target range, and not lower that range for 1982.

April, 1982—

The Administration and Federal Reserve have failed to give adequate recognition to the fact that the demand for money is rising as a result of widespread uncertainty, unemployment, and business failures. These are, in turn, the result of record breaking nominal and real interest rates and the conflicting goals of the Administration's fiscal and monetary policies. In the face of increased money demand, the Federal Reserve Open Market Committee's decision to

BEST DOCUMENT AVAILABLE

reduce the 1982 target growth range for currency and transactions accounts is in error and could cause nominal and real interest rates to remain at record high levels.

The Federal Reserve in its July 1982 Monetary Policy Report has shown a belated recognition of the strains in the economy and the need to adjust monetary policy to circumstances. One sign of sensitivity is the decision to retain the current 1982 monetary targets of 2.5 to 5.5 percent for M1, 6 to 9 percent for M2, and 6.5 to 9.5 percent for M3 as the targets for 1983. Federal Reserve Chairman Volcker in his testimony before the Committee indicated that the Federal Reserve is prepared to tolerate growth in the monetary aggregates above the 1982 targets if warranted by:

> . . . circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money.

The last Committee Report on monetary policy called attention to the public's increased concern for financial liquidity in a recession. Chairman Volcker now agrees, saying that "the Federal Reserve is sensitive to the special liquidity pressures that could develop during the current period of uncertainty." The last Committee Report also criticized the Administration's monetary theory that monetarist targets should be reduced by some fixed amount each and every year. By retaining its 1982 targets into 1983, the Federal Reserve has in effect repudiated this theory as the Committee recommended. If the Federal Reserve had been more alert to the economic and financial risks associated with the Administration's economic policies and had rejected a reduction in targets last year, the American people might have been spared much of the present distress.

While the Federal Reserve's monetary policy actions are in the right direction, the Committee finds them unresponsive to the recommendation contained in the Committee's April 1982 Report on Monetary Policy:

> the Committee recommends that, as Congress acts to restore fiscal responsibility and reduce the budget deficits currently projected for the years ahead, the Federal Open Market Committee ease the monetary targets now in effect so as to assure a full recovery and lower interest rates.*

Congress has made progress towards restoring fiscal responsibility despite the effects of the combined elements of Reaganomics. Unfortuately, the tapestry of fiscal restraint woven in the daytime is unwoven by high interest rates at night. Every effort Congress makes to close the budget deficit has been reversed by additional deficits stemming from the Administration and Federal Reserve policy of reducing inflation by depressing the economy.

---

* This recommendation was a precursor to the monetary policy directive contained in the Budget Resolution. The efforts of the author of the monetary policy directive, Congressman Henry S. Reuss, are briefly reviewed and documented in the Appendix to this Report.

BEST DOCUMENT AVAILABLE

MONETARY TARGETS

Very high short-term interest rates, especially in real terms, are a clear sign that monetary policy remains tight by any standard. In the face of deepening recession, and in light of the monetary policy directive and substantive budget actions of the Budget Resolution, the Federal Reserve needs to do more to lower interest rates and facilitate economic recovery. The Federal Reserve's indications of flexibility with respect to the monetary growth targets are not enough. If the growth of the M1 aggregate is being driven largely by the growth of precautionary savings balances in NOW accounts as Chairman Volcker's testimony suggested, M1 velocity may well have been substantially depressed from historic levels. In that case, the M1 aggregate may need to be increased even more than the "around the top of the ranges" proposed by the Federal Reserve if there is to be acceptable nominal GNP growth.

While the Federal Reserve has indicated its awareness and responsiveness to this situation, the Committee is nevertheless disturbed by the Federal Reserve's proposal to provide the necessary flexibility in monetary policy through interpretation instead of adjustment of the monetary targets. As Mr. Reuss argued in the hearings, the credibility of the Federal Reserve's monetary targets and reports to Congress are undermined by its stated willingness to exceed its targets in order to attain an appropriate monetary growth rate.

Under the Full Employment and Balanced Growth Act, the Federal Reserve is required to transmit to Congress:

> Independent written reports setting forth . . . the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth of the monetary and credit aggregates for the calendar year during which the report is transmitted.

The intent of Congress in stipulating that the Report present ranges of monetary and credit growth, as distinct from a simple numerical target for such growth, was to recognize the uncertainty inherent in monetary-policy planning and to provide for a degree of flexibility in the execution of the Federal Reserve's announced plans. Thus, it would be understood that the target range conveyed two types of information. First, in conjunction with an economic forecast the range conveyed the thrust or direction of monetary policy; this information was captured and summarized in the mid-point of the target range. Second, the range conveyed the degree of uncertainty inherent in aiming for the mid-point. The Federal Reserve would set the width of its targets according to the variability and turbulence of the economic conditions it faced, thus giving Congress an indication of how much deviation from the midpoint would be tolerated without evoking a strong policy response.

We continue to believe that the system of monetary and credit target ranges is a satisfactory compromise between Congress's need for information and the uncertainties inherent in the world around us. However, consistency in the formulation and presentation of the target ranges is essential. It is all too easy to render the target meaningless and useless by surrounding them with "interpreta-

BEST DOCUMENT AVAILABLE

tions" which qualify and obscure the Federal Reserve's intentions with respect to meeting these ranges.

The effect of the decision by the Federal Reserve to tolerate "for a time" M_1 growth somewhat above its targeted range obscures the meaning of the target ranges completely. The Federal Reserve says that the 1982 target ranges have not been changed. From that we would infer that the FOMC seeks 4 percent growth in M_1 for the year 1982 as a whole—a substantial deceleration from the rate of monetary expansion in the first half—but that it is willing to tolerate deviations of up to 1.5 percentage points in either direction.

The qualifications surrounding the ranges belie this simple and clear story. The Federal Reserve, we are told, is actually planning monetary expansion at or above the target range. This destroys the concept of a target range. The implied 4 percent midpoint of the range is now irrelevant, while the announced target of 5½ percent provides no margin of error for upward variations if the FOMC is not to exceed its target range. Nor does the announcement of 5½ percent target without adjustment of the target range indicate how much of an overshoot the FOMC is prepared to tolerate, or how it would act if demand for money drops in the second half of 1982 and M_1 growth for the year is foreseen to be 2.5 to 4 percent instead of 5½ percent.

By changing its ostensible target without changing its target range, the Federal Reserve in its July 20 report seriously obscures its intentions on monetary policy and fails to act in consistency with the reporting requirements of the Humphrey-Hawkins Act. This Committee recognizes the concerns expressed by Chairman Volcker that financial market participants might tend to misread the intentions of the Federal Reserve. Our concern, however, is that the present stated policy could be viewed by market analysts as abandonment of any kind of target scheme. That, we fear, might be worse than a simple misreading of a clearly stated policy which we assume would in fact be followed.

Under that law, the Federal Reserve is required to report ranges of growth of the monetary aggregates and not some obscure hybrid of ranges and targets-within-ranges. If changed conditions merit a change in the targets, then a change in the ranges should be reported. If the ranges are not changed, they should be hit. The current policy of "brinksmanship", in which the Federal Reserve announces that it is aiming for the ceiling of its ranges, is unsatisfactory. The Federal Open Market Committee should, at its next meeting, correct its presentation of its targets and report either a change or no change in its announced aggregate-growth target ranges.

ALTERNATIVE TARGETS FOR MONETARY POLICY

Chairman Volcker's discussion in his testimony before the Committee of the impact of NOW account balances on the behavior of M_1 and M_1 velocity in 1982, like his previous discourses on the impact of money market mutual funds on M_1 last year, raises serious questions about the continued reliability of the M_1 aggregate and monetary aggregates in general as targets for monetary policy. Indeed, several Federal Reserve Regional Bank Presidents, most

BEST DOCUMENT AVAILABLE

notably Frank Morris of the Boston Federal Reserve Bank and Anthony Solomon of the New York Federal Reserve Bank, have argued in print that the M_1 aggregate has been seriously compromised by financial innovations.

In testimony before one of this Committee's Subcommittees, one noted economist, Professor Benjamin Friedman of Harvard University, stated that "we have had a serious deterioration of the relationship between M_1 and non-financial activity." Dr. John Paulus, Vice President and Economist of Goldman, Sachs and Company, testified that velocity, which is the relationship between money supply and nominal gross national product, had fluctuated narrowly around a trend rate of growth of 3 percent through 1979, but since then has exhibited wide and unpredictable fluctuations with no clear trend line. Moreover, these witnesses warned that this situation was likely to persist, and Dr. Paulus warned that "If banks and thrift institutions were permitted to run their own money market funds, the concept of M_1 would basically disappear."

This situation is serious because, as Congressman Walter E. Fauntroy, Chairman of the Subcommittee on Domestic Monetary Policy pointed out:

> Monetary targets are a means to an end, not an end in themselves. We should not be fooled into giving them more attention than they deserve. I raise this obvious question because there is increasing evidence that the present monetary aggregates, and particularly the M_1 aggregate, are seriously flawed as immediate targets for obtaining our ultimate objectives of lower inflation, lower unemployment and strong, balanced economic growth. . . . The resulting risks would be that rigid adherence to current monetary targets could produce perverse results, including prolonged economic recession and high unemployment and bankruptcy rates.

One proposal to deal with this problem is adoption of a credit aggregate. Several studies have suggested that various credit aggregates such as total domestic nonfinancial debt have very stable relationships with nominal GNP, and at least as much of a causal effect on GNP growth as any of the monetary aggregates. If the Federal Reserve were to use as a traget such a credit aggregate either alone or in conjuntion with appropriate monetary targets, it might well have a better likelihood of achieving its ultimate objectives of full employment and balanced growth.

Another approach might be to require the Federal Reserve to establish target ranges for long term interest rates or real interest rates (nominal rates less the expected rate of inflation) as they now do for monetary aggregates. Long term interest rates remain at punishingly high levels discouraging capital investments and job-creating small business formations. Real interest rates are said to have historically averaged about 3 percent. Recently, real interest rates appear to have been as much as two and three times this level.

The Committee asks the Federal Reserve to include in its next report to Congress on monetary policy the results of thorough con-

BEST DOCUMENT AVAILABLE

sideration and study of these alternative methods for conducting monetary policy.

APPENDIX

Former Banking Committee Chairman Henry S. Reuss first proposed a direct link between monetary and fiscal policy in testimony before the Senate Budget Committee on March 15, 1982, followed by further testimony before the House Budget Committee on March 18, and by an exchange of letters with Chairman Jones of the House Budget Committee, in which Chairman Jones expressed interest in the idea of a Budget Resolution vehicle for a monetary policy directive. In an exchange of letters with Federal Reserve Chairman Volcker dated May 12 and May 24, 1982, initiated by Mr. Reuss, Chairman Volcker acknowledged that Congress has ultimate authority over Federal Reserve policy:

I was asked to confirm to you the full understanding of all members that the Federal Reserve is a creation of Congress and is responsible to it, that the Congress plainly has the Constitutional authority and the right to determine the control of money, that the System is subject to Congressional oversight and, of course, will follow the law. I and my predecessors have, as you note, consistently expressed our views in that vein.

This exchange cleared the way for Congressional approval of the Budget Resolution's monetary directive. That directive read:

It is the sense of Congress that if Congress acts to restore fiscal responsibility and reduces projected budget deficits in a substantial and permanent way, then the Federal Reserve Open Market Committee shall re-evaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained Federal policy.

In Mr. Reuss' judgment, the use of the Budget Resolution—approved by both Houses of Congress but not signed by the President—is entirely appropriate to carry out Congresses Constitutional obligations with respect to the Federal Reserve. While the Federal Reserve is clearly not independent of the Congress, as Chairman Volcker's letter acknowledges, it *is* independent of the Executive, and it would thus be inappropriate to have a Presidential signature attached (as would be required by a public law or joint resolution).

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, D.C., March 12, 1982.

Hon. HENRY REUSS,
Rayburn House Office Building,
Washington, D.C.

DEAR HENRY: Thank you for the copy of your testimony before the Senate Budget Committee with the Joint Economic Committee plan for dealing with the crucial budgetary problems before us. I am sure it will be of great interest to the Members of the Committee. As you know, I concur with your view that the budget presented to the Congress in the First Concurrent Resolution must be a bipartisan one which recognizes that domestic discretionary programs bore the brunt of last year's budget cutting and should not be subjected to similar treatment this year. At the same time, we

BEST DOCUMENT AVAILABLE

must recognize that the tax cut passed in 1981 was too large and should carefully examine the economic and budgetary dimensions of what promises to be the largest peacetime military buildup.

Your suggestion of including a statement on monetary policy in the First Concurrent Resolution is original and deserves careful consideration. The lack of coordination between fiscal and monetary policy is a major source of our current economic problems, and this might help to resolve that difficulty and express the Congress' desire to reach an accord with both the President and the Federal Reserve. If it appears desirable to pursue this course of action I would, of course, seek the advice of our colleagues on the Committee on Banking, Finance and Urban Affairs.

I look forward to your presentation before the Budget Committee next Thursday, March 18.

With best wishes,

Sincerely,

JAMES R. JONES,
Chairman.

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., May 24, 1982.

Hon. HENRY S. REUSS,
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: I am responding to your letter of May 12 regarding the attitude of the Federal Open Market Committee toward a Congressional resolution relating to monetary policy. I am, of course, aware of the language adopted by the House and Senate Budget Committees in that respect. I might add, too, that I am aware of no legal opinion requested or given to "justify a refusal to comply with a Congressional directive."

The Committee, at my request, did discuss the general question in the course of its meeting on May 18. I was asked to confirm to you the full understanding of all members that the Federal Reserve is a creation of Congress and responsible to it, that the Congress plainly has the Constitutional authority and the right to determine the control of money, that the System is subject to Congressional oversight and, of course, will follow the law. I and my predecessors have, as you note, consistently expressed our views in that vein.

As you know, Congress has delegated the process of monetary policy formulation and implementation to the Federal Reserve since the Federal Reserve Act was originally passed in 1913. The present institutional arrangements reflect, in my view, the belief of the Congress that the public interest is served by an institutional setting that can combine experienced judgment and regional representation in its governing bodies, and continuity in expert analysis, with a certain insulation from transient political influences. A factor in that approach is recognition that monetary policy manipulated toward short-term or partisan purposes could have potentially adverse repercussions for our economy.

BEST DOCUMENT AVAILABLE

While I personally believe those considerations remain valid today, Congress, of course, can at any time determine to change those arrangements.

I have also stressed repeatedly that the Federal Reserve cannot and does not make or implement monetary policy with mechanical rigidity, or without consideration of a wide variety of relevant factors. In selecting our targets for money growth and in carrying out our operations from week to week or month to month, we are mindful of the financial and economic environment, certainly including, among other factors, the posture of fiscal policy. Thus, you may be assured that the Federal Reserve will pay careful attention to the implications of any change in the budgetary outlook as it evolves. That, as I understand it, is the sense of the language in the proposed resolution, and I can assure you the Federal Open Market Committee, as always, will give full attention to any Congressional resolution concerning our responsibilities. In the light of that general understanding, it seemed to me unnecessary and inappropriate to call a formal vote on a hypothetical resolution of the sort you indicated.

In affirming our recognition of the ultimate authority of the Congress over the Federal Reserve, I would also add that action by the Congress to indicate or direct a specific course for monetary policy, such as a precise monetary target, would be a decision of great moment, for the Congress and for the Federal Reserve. It would, in effect, move toward shifting directly to the Congress the responsibility for decisions overlaid with technical as well as substantive complexities, in the process clearly implying a change in the institutional arrangements embodied in the Federal Reserve Act. In that connection, the emphasis in your letter on a single measure of monetary policy—M1, which is being affected, among other influences, by the impact of financial innovations in the marketplace which require continuing analysis and judgment—seems to me misplaced. In any event, I would hope the Congress would refrain from adopting specific target-setting bill or resolution without the most careful consideration, through hearings in the appropriate Committees and otherwise, taking account not only of the technical implications of the proposal but the consequences of such a "directive" for institutional arrangements in place for almost 70 years.

In closing, let me reiterate my conviction that forceful, definitive action by the Congress to assure a downward trend in the Federal deficit as the economy recovers is a key to greater confidence in financial markets and achieving and maintaining the lower interest rates necessary to support sustained economic expansion.

Sincerely,

PAUL A. VOLCKER,
Chairman.

BEST DOCUMENT AVAILABLE

HOUSE OF REPRESENTATIVES,
Washington, D.C., May 5, 1982.

Hon. JAMES JONES,
Chairman, Committee on the Budget.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR JIM AND DANNY: With the economy in such bad shape and the President unwilling to make any concessions on taxes or military spending, the Committees on the Budget and on Ways and Means must now assume responsibility for forging an acceptable budget and tax program.

The elements of such a program are widely recognized. We must have a budget which lowers the deficit dramatically from this day forward, until there is a reasonable prospect of budget balance in a few years. We must protect vital social programs, including Social Security. We must allow for an increase in our military forces. And we must dramatically improve the fairness of our tax system by undoing many of the excessive tax breaks and loopholes for wealthy individuals and businesses which were enacted last year, as well as continuing to seek out and eliminate excessive, wasteful, unfair and unnecessary tax preferences which have long been on the books.

We expect the Budget Committee will meet this challenge, and produce a program which provides for budget deficits dramatically lower than would occur under current policy assumptions, while doing so more fairly and realistically than the President has proposed in his Budget. At the same time, we expect the Ways and Means Committee to produce a tax package which contributes constructively to reducing the deficit, and which restores some of the progressivity to our tax code which was lost last year in the enactment of Kemp-Roth and other excessive new tax preferences. We offer our support to you in these efforts.

The truth, however, is that these efforts alone are not enough. The purpose of deficit reduction is to permit lower interest rates and so to foster a rapid recovery from the present recession. Actions taken now to lower the deficit in years ahead are definitely needed. But they will not lower interest rates now, and will not foster economic recovery now, unless they are accompanied by an easing of monetary policy now. And the Chairman of the Federal Reserve Board has said, clearly, emphatically and without reservation, that he refuses to change his monetary policies unless Congress orders him to do so.

The Federal Reserve should therefore be instructed in the Budget Resolution to adjust its monetary targets for 1982 in order to assure full recovery and lower interest rates. This measure, taken in conjunction with steps toward fiscal responsibility outlined above, would engender a rapid reduction in the deficit, from two sources: lower interest payments on the national debt, and higher revenues from the more rapid recovery of the economy which would then occur.

With monetary policy during 1982 we have a special problem. For 1981, the Federal Reserve announced that it would try to

BEST DOCUMENT AVAILABLE

achieve money growth of between 3 and 6 percent. Instead, it achieved only 2.2 percent money growth for the year. Then, in February 1982, the Federal Reserve announced that the money growth target range for 1982 had been set 2.5 to 5.5 percent from a base that was severely depressed by the failure to attain even the bottom of the 1981 target range.

So far this year, the Federal Reserve has actually permitted money growth of 8.9 percent at an annual rate, which is much more in line with the requirements for economic recovery than the announced targets. But this rate of growth presents its own problems.

If the Federal Reserve decides to stick with its M1 growth targets of 2.5 to 5.5 percent, the fact that money growth has exceeded the upper limit during the first four months means that growth will have to be severely restricted between May and December. For example, to hit a 4 percent money growth rate for 1982—the midpoint of the range—would require less than 1 percent money growth for the rest of this year, much less than the actual growth rate of last year. How could such monetary stringency give us anything but even higher interest rates and continued recession?

On the other hand, the Federal Reserve may decide to let the current rate of money growth continue through the rest of the year. But if the Fed does this without publicly revising upward its monetary target ceiling, it will make a mockery of the requirements of the Humphrey-Hawkins Act. Worse, it will add to the uncertainty that currently prevails in the financial community. The result will be unnecessary upward pressure on interest rates as lenders demand higher uncertainty premiums.

We propose that the 1983 Budget Resolution include instructions to the Federal Reserve to announce new monetary growth targets for the year. One way to do this would be for the Federal Reserve to announce a feasible six-month target beginning July 1, 1982, rebased to the level of the money supply in the second quarter of 1982. Such an action would clearly convey that the Federal Reserve intends only a once-for-all correction, and not a sustained, potentially inflationary increase of the money growth rate.

It would be nice if Congress could reach an agreement with the Federal Reserve without the necessity for a formal congressional instruction. Unfortunately, it appears that this will not be possible. Just late last month, the House Banking Committee, by a vote of 26 to 14, called on the Federal Reserve to agree to link a loosening of its monetary targets to congressioanl action which reduces the deficit. Federal Reserve Board Chairman Paul A. Volcker rejected the Banking Committee's overture the same day. Accordingly, the Federal Reserve has aligned itself with the intransigence of the Administration, and will have to be dealt with in the same way—by formal instruction in the appropriate format.

The 1975 precedent, H. Con. Res. 133, established that an instruction embodied in a Concurrent Resolution of Congress is binding on the Federal Reserve. Therefore, a simple statement of policy in the Budget Resolution, effective when the President signs the tax measure listed in (1) above, will suffice: "The Federal Reserve shall ease its present 5.5 percent monetary growth ceiling, so as to permit full economic recovery and lower interest rates."

BEST DOCUMENT AVAILABLE

There is no need, in our view, to put the Federal Reserve in a straitjacket of congressionally imposed monetary targets or congressionally mandated technical procedures. The Federal Reserve is quite capable of reading, understanding, and acting in response to a general policy directive, and Congress is quite capable of distinguishing compliance with inaction.

In the case of the Administration, a sterner format is necessary. The President has indicated he might veto tax legislation which incorporates significant deficit-closing increases. Therefore, this measure must be adopted in a form which the President would find extremely distasteful to veto. Only one such vehicle is available: the debt ceiling increase, which, like the Budget Resolution, must be enacted within the next few weeks. The Ways and Means Committee thus can attach needed revenue legislation to the debt ceiling extender and report a conglomerate debt-and-taxes bill to the Floor for prompt action. We need not decide at this time what steps would be necessary in the event the President vetoes such a bill.

Prompt action by the Budget and Ways and means Committees along the lines suggested above provides the best remaining hope of preserving the budget process from destruction and of avoiding a political stalemate which would make economic recovery impossible and imperil the American economy. We are confident that an appeal to the good sense and patriotism of Democrats and Republicsn alike can lead to the adoption of a budget on a bipartisan basis if we act now. Success cannot be guaranteed, but the stalemate leaves us no choice but to act.

Sincerely,

MORRIS K. UDALL.
GEORGE MILLER.
HENRY S. REUSS.

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., May 12, 1982.

Hon. PAUL A. VOLCKER,
Chairman, Board of Governors,
Federal Reserve System, Washington, D.C.

DEAR MR. CHAIRMAN: Congress is moving rapidly toward a resolution of the budget impasse and a significant closing of the prospective budget deficits for the years ahead. As this happens, Budget Committees in both Houses of Congress have come to realize the crucial role which monetary policy must play in a strategy to bring about lower interest rates and full economic recovery. In reporting its Budget Resolution last week, the Senate Budget Committee recognized the inadequacy of the monetary growth ceiling presently in effect and included an explicit instruction to the Federal Open Market Committee to reevaluate that ceiling in light of the new budget policy. The Senate language follows:

"It is the sense of the Congress that if Congress acts to restore fiscal responsibility and reduces projected budget deficits in a substantial and permanent way, then the Federal Reserve Open Market Committee shall re-evaluate its monetary targets in order

BEST DOCUMENT AVAILABLE

to assure that they are fully complementary to a new and more restrained fiscal policy."

The House Budget Committee will be meeting later this week. My judgement is that language on monetary policy will almost certainly be included in the House Budget Resolution as well. The House Banking Committee, but a vote of 26 to 14, has recommended that the House Budget Committee include a directive to the Federal Reserve to ease its monetary targets and lower interest rates. In a letter authorized by Congressman George Miller, Congressman Morris Udall and myself, sent on May 5, 1982 to Chairman Jones and Chairman Rostenkowski, we presented the argument in favor of explicit Congressional direction to the Federal Reserve in the Budget Resolution. The key paragraphs of that letter follow:

"With monetary policy during 1982 we have a special problem. For 1981, the Federal Reserve announed that it would try to achieve money growth of between 3 to 6 percent. Instead, it achieved only 2.2 percent money growth for the year. Then, in February 1982, the Federal Reserve announed that the money growth range for 1982 had been set 2.5 to 5.5 percent from a base that was severely depressed by the failure to attaind even the bottom of the 1981 target range.

"So far this year, the Federal Reserve has actually permitted money growth of 8.9 percent at an annual rate, which is much more in line with the requirements for economic recovery than the announced targets. But this rate of growth presents its own problems.

"If the Federal Reserve decides to stick with its M_1 growth targets of 2.5 to 5.5 percent, the fact that money growth has exceeded the upper limit during the first four months means that growth will have to be severely restricted between May and December. For example, to hit a 4 percent money growth rate for 1982—the midpoint of the range—would require less than 1 percent money growth for the rest of this year, much less than the actual growth rate of last year. How could such monetary stringency give us anything but even higher interest rates and continued recession?

"On the other hand, the Federal Reserve may decide to let the current rate of money growth continue through the rest of the year. But if the Fed does this without publicly revising upward its monetary target ceiling, it will make a mockery of the requirements of the Humphry-Hawkins Act. Worse, it will add to the uncertainty that currently prevails in the financial community. The result will be unnecessary upward pressure on interest rates as lenders demand higher uncertaintly premiums.

"We propose that the 1983 Budget Resolution include instructions to the Federal Reserve to announce new monetary growth targets for the year. One way to do this would be for the Federal Reserve to announce a feasible six-moth target beginning July 1, 1982, rebased to the level of the money supply in the second quarter of 1982. Such an action would clearly convey that the Federal Reserve intends only a once-for-all correction, and not a sustained, potentially inflationary increase of the money growth rate."

BEST DOCUMENT AVAILABLE

I believe that this position has powerful bipartisan support in Congress and will prevail when the Budget Resolution is finally enacted.

With the position of Congress established, it is rapidly becoming imperative that the Federal Reserve make clear how it will respond to the impending Congressional directive. Recent press reports are ambiguous. On the day of the House Banking Committee vote, your remarks to the Women's Economic Roundtable in New York were interpreted in the press as a refusal to alter monetary policy irrespective of Congress' mandates or of what is done to close the deficit. A few days later in his column in the Washington Post of May 4, 1982, Joe Kraft reported that an unnamed Federal Reserve Board member had requested and received a legal opinion to justify a refusal to comply with a Congressional directive. Subsequently, Bondweek newsletter has reported that your comments before the Women's Economic Roundtable had not been cleared with or approved by your colleagues on the Federal Reserve Board.

I cannot really believe that the Federal Open Market Committee would attempt to rewrite the Constitution, the Federal Reserve Act, and well-established precedent by an act of defiance of a Congressional resolution. The precedent of House Concurrent Resolution 133, enacted in 1975, clearly establishes the binding character of a Congressional resolution of Congress on the Federal Reserve System and on the Federal Open Market Committee. The preamble of H. Con. Res. 133 states:

"Whereas article I, section 8, of the Constitution provides that Congress shall have the money power, namely to coin money and regulate the value thereof:

"Whereas Congress established the Federal Reserve Board as its agent, and delegated to its agent the day-to-day responsibility for managing the money supply; . . . ."

Morover, H. Con. Res. 133 establishes a precedent under which Congress can provide explicit instruction to the Federal Reserve regarding the conduct of monetary policy. The language is as follows:

"That it is the sense of Congress that the Board of Governors of the Federal Reserve System and the Federal Open Market Committee—

"(1) pursue policies in the first half of 1975 so as to encourage lower long term interest rates and expansion in the monetary and credit aggregates appropriate to facilitating prompt economic recovery; and . . . ."

Every Federal Reserve Chairman of modern times has also acknowledged the preeminent role of Congress and the subordinate role of the Federal Reserve:

Thus, Federal Reserve Board Chairman Thomas McCabe in 1950:

Senator DOUGLAS. Here you are, twins, Siamese Twins, but with no central coordinating nervous structure to dictate a uniform policy.

Do you see some possible dangers in that situation?

Mr. MCCABE. Well, I could see very grave dangers if you had in the personnel of the Treasury and the Federal Reserve the type of people that just refuse to discuss these broad questions from the standpoint of the public interest. If we reached an impasse, Sena-

BEST DOCUMENT AVAILABLE

tor, I would think the first recourse would be to go to the President and have him arbitrate these differences in point of view.

Certainly, the Federal Reserve being a creature of the Congress and reporting to the Congress, should then make its appeal to the Congress to arbitrate the points of view.

As I see it, there are three steps: One is persuasion, the second is appeal to the President, the third is appeal to the Congress; that is, to meet this hypothetical situation that you advance.

Senator DOUGLAS. Would it be helpful if Congress were to give a definite directive of policy which both the Treasury and the Federal Reserve would follow, not merely on money and credit policy, on the one hand, and debt policy, upon the other hand, but for the two as an integrated whole?

Mr. MCCABE. I have thought a great deal about that, as to the type of directive, if you want to call it that, which the Congress might issue. It might be in the form of a resolution or the Congress might more definitely define the areas of responsibility, or the Congress might even go so far as to say which body would be the body of final decision. (Hearings, Joint Economic Committee, November, 1950, p. 489)

Thus, Chairman William McChesney Martin, Jr. in 1956:

Senator DOUGLAS. Let me turn to a general question. Do you regard the Federal Reserve Board as the agency of the Executive or the agent of Congress?

Mr. MARTIN. I regard it as an independent agency of the Government.

Senator DOUGLAS. To whom is it responsible? to the Executive or the Congress?

Mr. MARTIN. It is responsible to Congress . . . The indenture of this trusteeship was written by the Congress in the Federal Reserve Act, and can be altered at any time by the Congress. . . . (Hearings, Senate Committee on Banking and Currency, January 20, 1956)

Thus, Chairman Arthur Burns in 1968 and 1971:

Senator PROXMIRE. You do acknowledge, do you not, only Congress has the constitutional authority to regulate the money supply, and the Federal Reserve is an agent of the Congress independent of the executive branch?

Dr. BURNS. I have no quarrel with that. I know the Constitution and I am a law-abiding citizen. (Hearings, Senate Committee on Banking and Currency, December, 1968, p. 54)

Mr. PATMAN. Tell me the law that created that separate entity.

Dr. BURNS. The law which created that separate entity is the Federal Reserve Act.

Mr. PATMAN. The Constitution says that the Congress shall make the laws and the executive shall enforce the law.

Now, I am fairly well acquainted with the Federal Reserve Act. I wasn't here when it was passed, but I was here not so long after that, and I have kept up with it pretty well. And I have never been able to find a sentence in the Federal Reserve Act that indicated that the Federal Reserve should be independent of the Government.

Would you tell me where it is?

BEST DOCUMENT AVAILABLE

Dr. BURNS. I have not claimed that the Federal Reserve is independent of the Government.

Mr. PATMAN. You said separate entity, you know.

Dr. BURNS. I have recognized not only in the past, but again this very morning that the Federal Reserve is a creature of the Congress, and that it is a servant of the Congress. (Hearings, House Committee on Banking and Currency, September 27, 1971, p. 24)

Thus, Chairman William G. Miller in 1978.

Mr. GRASSLEY. I would detect that your relationship with the administration doesn't depart too much from what we have been told have been the patterns of previous administrations and previous chairmen.

Mr. MILLER. I know of no difference. I have really picked up the agenda that was established by Dr. Burns. . . .

Mr. GRASSLEY. This final question would probably give you an opportunity to sum up what you have previously said. But is the independence of the Fed in any danger from either political pressure from this administration or from the Congress?

Mr. MILLER. I don't detect it at this time. The President has stated over and over again that he believes in the independence of the Fed. . . . I know that it is only the Congress that has created the Fed, not the Constitution. (Hearings, House Committee on Banking, Finance, and Urban Affairs, April 10, 1978, pp 142-143)

In view of the overwhelming weight of law, precedent and past testimony concerning the relationship of Congress to the Federal Reserve, it is vital for Congress to know whether the Federal Reserve will now accede to the directive of Congress, or instead assert that it is a fully independent fourth branch of government accountable to no one.

The next meeting of the Federal Open Market Committee is on May 18. It would be in the public interest to give the Federal Open Market Committee an opportunity to vote on this question. I, therefore, request that you submit to the Open Market Committee a resolution in substantially the following form for their consideration and vote, and that you provide to me the results of the vote, together with the names of Open Market Committee members voting in the affirmative and in the negative:

"*Resolved*, that the Federal Open Market Committee, will comply with a directive in a Concurrent Resolution requesting the Federal Open Market Committee, if the Congress substantially reduces budget deficits, to adjust its present monetary target range in order to permit lower interest rates."

I appreciate your consideration in this matter and look forward to hearing the results of this vote.

Sincerely,

HENRY S. REUSS,
Chairman.

BEST DOCUMENT AVAILABLE

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., May 24, 1982.

Hon. HENRY S. REUSS,
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: I am responding to your letter of May 12 regarding the attitude of the Federal Open Market Committee toward a Congressional resolution relating to monetary policy. I am, of course, aware of the language adopted by the House and Senate Budget Committees in that respect. I might add, too, that I am aware of no legal opinion requested or given to "justify a refusal to comply with a Congressional directive."

The Committee, at my request, did discuss the general question in the course of its meeting on May 18. I was asked to confirm to you the full understanding of all members that the Federal Reserve is a creation of Congress and responsible to it, that the Congress plainly has the Constitutional authority and the right to determine the control of money, that the system is subject to Congressional oversight and, of course, will follow the law. I and my predecessors have, as you note, consistently expressed our views in that vein.

As you know, Congress has delegated the process of monetary policy formulation and implementation to the Federal Reserve since the Federal Reserve Act was orginally passed in 1913. The present institutional arrangements reflect, in my view, the belief of the Congress that the public interest is served by an institutional setting that can combine experienced judgment and regional representation in its governing bodies, and continuity in expert analysis, with a certain insulation from transient political influences. A factor in that approach is recognition that monetary policy manipulated toward short-term or partisan purposed could have potentially adverse repercussions for our economy.

While I personally believe those considerations remain valid today, Congress, of course, can at any time determine to change those arrangements.

I have also stressed repeatedly that the Federal Reserve cannot and does not make or implement monetary policy with mechanical rigidity, or without consideration of a wide variety of relevant factors. In selecting our targets for money growth and in carrying out our operations from week to week or month to month, we are mindful of the financial and economic environment, certainly including, among other factors, the posture of fiscal policy. Thus, you may be assured that the Federal Reserve will pay careful attention to the implications of any change in the budgetary outlook as it evolves. That, as I understand it, is the sense of the language in the proposed resolution, and I can assure you the Federal Open Market Committee, as always, will give full attention to any Congressional resolution concerning our responsibilities. In the light of that general understanding, it seemed to me unnecessary and inappropriate to call a formal vote on a hypothetical resolution of the sort you indicated.

BEST DOCUMENT AVAILABLE

In affirming our recognition of the ultimate authority of the Congress over the Federal Reserve, I would also add that action by the Congress to indicate or direct a specific course for monetary policy, such as a precise monetary target, would be a decision of great moment, for the Congress and for the Federal Reserve. It would, in effect, move toward shifting directly to the Congress the responsibility for decisions overlaid with technical as well as substantive complexities, in the process clearly implying a change in the institutional arrangements embodied in the Federal Reserve Act. In that connection, the emphasis in your letter on a single measure of monetary policy—M1, which is being affected, among other influences, by the impact of financial innovations in the market place which require continuing analysis and judgement—seems to me misplaced. In any event, I would hope the Congress would refrain from adopting a specific target-setting bill or resolution without the most careful consideration, through hearings in the appropriate Committees and otherwise, taking account not only of the technical implications of the proposal but the consequences of such a "directive" for institutional arrangements in place for almost 70 years.

In closing, let me reiterate my conviction that forceful, definitive action by the Congress to assure a downward trend in the Federal deficit as the economy recovers is a key to greater confidence in financial markets and achieving and maintaining the lower interest rates necessary to support sustained economic expansion.

Sincerely,

PAUL A. VOLCKER,
Chairman.

BEST DOCUMENT AVAILABLE

MINORITY VIEWS ON THE CONDUCT OF MONETARY POLICY

Examination of the Committee Report convinces us that we cannot endorse its views and conclusions. Its assessment of current economic conditions is unbalanced, and it lacks an economic forecast or set of assumptions that could provide the basis for its recommendations for monetary policy. The Majority's Report misleads when it purports to offer painless alternatives for the sustained abatement of inflation. Moreover, its recommendations advocate the same kind of policy reversal which in the past has repeatedly aborted promising initiatives to deal with secular inflation. Although we may disagree on specfic points contained in these views, we stand united in the fundamental policies outlined below.

Summary and Recommendations

Inflation by any measure has fallen dramatically in the past year. Key interest rates have declined by one-third to one-half of what they were one year ago. While unemployment stands at intolerable levels, we know this is a lagging indicator and believe it will likewise recede in the months ahead.

The monetary targets set by the Federal Reserve for this year, and tentatively for next year, are reasonable if attained and consistent with a moderately rapid recovery from the current recession without raising undue risks of reviving inflation. The Federal Reserve did indicate that it would tolerate money growth around the upper end of the target range for 1982 and, even for a time, somewhat above the range.

At the same time, however, retention of the range with its 5½ percent upper limit provides assurance that efforts to curb inflation will continue even as economic recovery is promoted. The adopted range provides ample scope for financing recovery because of the large rebound in the velocity of money that normally occurs in the initial stages of a cyclical upswing.

It would be unwise for the Federal Reserve to raise this year's money growth targets, as the Majority urges, because such a move would clearly be misconstrued by the money markets and lead to renewed inflationary expectations.

Our present economic difficulties basically are the inflationary residue of past policies. The targeted money growth rates for this year promise to continue progress in containing inflation, while permitting accommodation of liquidity demands in a period of economic uncertainty and building a sound foundation for economic recovery.

Any radical departure from the present course of monetary policy—whether by mandating major changes of the Federal Reserve's operating procedures, by seeking to force the hand of its po-

BEST DOCUMENT AVAILABLE

licymakers by redundant Sense of the Congress Resolutions, or by conflicting recommendations coming from the two Banking Committees of the Congress—will only make the Federal Reserve's task more difficult and sow confusion in the financial markets.

Current and Prospective Economic Conditions

The U.S. economy at this writing shows increasing evidence that it has passed bottom and is poised for recovery. One important piece of evidence was the 1.7 percent upturn of GNP in the second quarter. And the Federal Reserve Board's index of industrial production in July showed the smallest decline since the recession began just one year ago. Consumer retail purchases have shown a firmer tone during the first half of the year, consumption spending rising 2.4 and 3.1 percent during the first and second quarters of the year, respectively. New residential housing construction permits rose consistently every month February through June and showed a 34 percent increase in July. However, unemployment, a lagging indicator, inched up another 0.2 points last month and industry capacity utilization rates continued scraping along at a level just below the 70 percent mark that it has maintained for the past several months.

At the same time inflation, after a marked decline during the earlier part of the year, now appears in a stabilization phase at a much reduced rate. Producer prices for finished goods in July, for example, rose 0.6 percent and stood 3.6 percent ahead from the year earlier reading when the rate of increase had been 9.8 percent on an annual basis. More dramatic yet have been the most recent declines in short-term interest rates. The federal funds rate, for example, hovered around 10 to 10.5 percent bid on August 13. This compares to 15 percent as recently as late June of this year and 19 percent in June 1981. Similarly, a 14 percent prime rate, which stood at 19.5 percent as recently as mid-May of this year, appears to be becoming the industry-wide norm shortly. Further reductions are confidently expected by financial analysts. In recognition of these general market trends, the Federal Reserve has repeatedly lowered its discount rate to 10.5 percent currently. Additional declines are likely. The stage is, therefore, set for an economic recovery during the second half of this year.

While this is a widely held opinion among economic forecasters, the extent of its realization depends importantly on the future behavior of interest rates which are influenced—though not determined—by monetary policy. Chairman Volcker in his testimony before our Committee stated the problem succinctly:

> Can we look forward to lower interest rates to support the expansion in investment and housing as the recovery takes hold? Is there, in fact, enough liquidity in the economy to support expansion—but not so much that inflation is reignited? . . . As we approach these policy decisions, we are particularly conscious of the fact that monetary policy, however important, is only one instrument of economic policy.

BEST DOCUMENT AVAILABLE

The Federal Reserve Response

Chairman Volcker answered his own questions essentially by relaying to the Committee two policy decisions approved by the Federal Open Market Committee (FOMC): (1) to maintain present money growth targets for 1982 at the levels established in January, and (2) to maintain tentatively the same set of target ranges unchanged for 1983.

In respect to the decision to leave 1982 targets unchanged, Chairman Volcker made this additional comment:

> In the light of the evidence of the desire to hold more NOW accounts and other liquid balances for precautionary rather than transaction purposes during the months of recession (which evidently accounted for most of the bulge in M1 growth during the early part of the year), strong efforts to reduce further the growth rate of the monetary aggregates appeared inappropriate. Such an effort would have required more pressure on bank reserve positions—and presumably more pressure on the money markets and interest rates in the short run.
>
> At the same time an unrestrained build-up of money and liquidity clearly would have been inconsistent with an effort to sustain progress against inflation, both because liquidity demands could shift quickly and because our policy intentions could easily have been misconstrued.

Further on, Chairman Volcker elaborated that:

> . . . in light of developments during the first half (the FOMC felt) that growth around the top of those ranges woud be fully acceptable. Moreover—and I would emphasize this—growth somewhat above the targeted ranges would be tolerated for a time in circumstances in which it appeared that precautionary or liquidity motivations were leading to stronger than anticipated demands for money.

It is in this decision area that the Committee Report has been most critical of the Federal Reserve:

> The Federal Reserve's indications of flexibility with respect to the monetary growth targets are not enough. If the growth of the M1 aggregate is being driven largely by the growth of precautionary savings balances in NOW accounts as Chairman Volcker's testimony suggested, M1 velocity may well have been substantially depressed from historic levels. In that case, the M1 aggregate may need to be increased even more than the "around the top of the ranges" proposed by the Federal Reserve if there is to be an acceptable nominal GNP growth . . . the Committee is . . . disturbed by the Federal Reserve's proposal to provide the necessary flexibility through interpretation instead of adjustment of the monetary targets . . . by changing its ostensible target without changing its target range, the Federal Reserve . . . seriously obscures its intentions on monetary policy and fails to act in consistency with . . . the Humphrey-Hawkins Act . . . the present

BEST DOCUMENT AVAILABLE

stated policy could be viewed by market analysts as abandonment of any kind of target scheme.

The issue, thus, is squarely joined. In arriving at its own determination of the validity of the conflicting claims, the Minority has given consideration to the following corollary questions.

The Relationship Between the Money Supply and Interest Rates

Implicit in the Majority's basic line of argument is the belief that high interest rates are a reflection of tight money policy and that they can be lowered by a accelerated expansion of the growth in money and credit. This was a tenable view during the days when the public still held an unshaken belief in the stability of the currency. It is, after all, a matter of common observation that if the supply of commodity increases, its price tends to decline. And so it was with credit and its price—interest—when the future purchasing power of a dollar was still unquestioned.

However, times have changed. And as a result of years of outsized and growing budgetary deficits monetized at times by an accommodating Federal Reserve, the money supply outpaced the real growth of the economy and inflation began to erode the value of the currency. Once expectations of further inflation became established and once the public became increasingly conscious of the potentially inflationary consequences of an accommodative monetary policy, the responses of the financial markets to monetary expansion changed. In July of last year, the Under Secretary of the Treasury for Monetary Affairs put is this way:

> The Federal Reserve cannot reduce interest rates with new regulations on credit markets or fast money growth. More money signals more inflations. Interest rates would rise to an even higher level as lenders, now well-trained and highly attuned to the effects of rapid money growth, would demand even higher rates of interest.

There is in other words a basic flaw in the thrust of the Majority's argumentation and, consequently, in its recommendations for policy. The credit markets, to be sure, may respond favorably to a minor and temporary expansion of bank reserves and thereby the money supply. But should the conviction grow that the Federal Reserve has succumbed to the kind of pressure that is implicit in the Majority Report, interest rates would surely again turn upward, the result of renewed inflationary expectations. Although such expectations tend to affect primarily long term rates, the fact is that credit market instruments are interdependent and clearly high bond yields have forced a growing reliance on short-term credit as a substitute for short-term funding. In its effort to combat inflation and in its attempt to damp down interest rates, the Federal Reserve, therefore, has no alternative but to maintain its basic stance of monetary restraint until inflationary expectations are laid to rest.

BEST DOCUMENT AVAILABLE

Should 1982 Money Growth Targets be Adjusted?

The preceding considerations have an important bearing on the answer of another question raised by the Majority Report whether it is wiser on balance to retain established targets and "lean into the wind" as changing circumstances appear to dictate. Or, whether it is better to change the targets whenever a change of policy is to be implemented, thus advising the money markets of a major change of intended direction.

This discussion could well be prefaced by a quote from Domestic Monetary Policy Subcommittee Chairman Walter Fauntroy who is quoted in the Report to this effect:

> Monetary targets are a means to an end, not an end in themselves. We should not be fooled into giving them more attention than they deserve. I raise this obvious question because there is increasing evidence that the present monetary aggregates, and particularly the M1 aggregate, are seriouly flawed . . .

While we question the seriousness of the flaw in the monetary aggregates we welcome the Committee Report's suggestion for an investigation of alternative methods of monetary policy. If this Committee is serious about an exhaustive review of alternative targets and operating procedures, then we should study approaches suggested by the Federal Reserve, the Administration, monetary policy scholars, practioneers, and others as well. Any changes should occur only after the most careful consideration by our Committee.

Our point is that the Committee Report devotes extensive space to an argument that the Federal Reserve should be more meticulous in adjusting its monetary targets to conform to tentative changes in the direction of monetary policy, while on the other hand, advising that monetary targets are not to be be given too much attention, that they are flawed.

Leaving aside this ambivalence in the Committee's Report, the Minority feels that the major consideration that should govern the approval of disapproval of the Federal Reserve's decision to maintain existing targets for the remainder of 1982 is the psychological impact on the money markets—what kind of message is conveyed to the money markets either by the retention of the present target ranges and reaffirming a basic posture of moderate money expansion or, alternatively, by raising them so as to bracket the intended fourth quarter-to-fourth quarter growth rate. While the latter course might be neater and intellectually more satisfyting, we must side with Chairman Volcker and the FOMC on this issue. Raising the 1982 targets at this time would most likely raise inflationary expectations and would work against efforts to created conditions conducive to lower interest rates. Moreover, we fail to see the cogency of the Report's argument that "present stated policy could be viewed by market analysts as abondonment of any kind of target scheme". It appears to us that the usefulness of a targeting scheme derives precisely from its constancy as an expression of basic intent and set of references against which actual performance can be gauged.

BEST DOCUMENT AVAILABLE

Raising the targets for the monetary aggregates within less than three months of the coming election could too easily be misconstrued by the financial community as yielding to political pressure, leading to a replay of the course of events—as some view it—that led from the stimuation of the economy in the fall of 1980 to its decline and concomitant renewal of inflation in the summer of 1981. Indeed, the Majority Report's insistence on upward adjustment of the 1982 targets—premised as it is on the assumption that this is the way to lower interest rates—appears to be rendered moot by the recent dramatic declines in short and even long term interest rates.

Regarding 1983 targets for the monetary aggregates, Chairman Volcker reported in his testimony:

> . . . the Committee felt that the existing targets should be tentatively retained for the next year. Since we expect to be around the top end of the ranges this year, those tentative targets would, of course, be fully consistent with somewhat slower growth in the monetary aggregates in 1983. Such a target would be appropriate on the assumption of a more or less normal cyclical rise in velocity (of money circulation). With inflation declining, the tentative targets would appear consistent with and should support continuing recovery at a moderate pace.

The Committee Report has no quarrel with the retention of existing targets for next year, a conclusion with which the Minority sees no reason for disagreement, assuming that an increase in velocity will, in fact, compensate for the implied lesser growth rate of money stock. However, no one can have very firm convictions about this at this time.

Budgeting and Monetary Policy

In this testimony, Chairman Volcker also addressed the issue of the relationship between the federal budget—and particularly the size and trend of budgetary deficits—to an appropriate monetary policy. This subject had repeatedly been raised in the past in this Committee and elsewhere, the argument being that fiscal and monetary policy are substitutes, and that a policy mix involving tight budget and expansive monetary policy would be preferable to monetary restraint accompanied by large budgetary deficits. The Majority Report in its appendix attachments again draws attention to this policy question quoting from the Budget Resolution to the effect that if Congress acts to restore fiscal responsibility and reduces projected deficits, then the FOMC is to reevaluate its monetary targets.

In his comments on the subject, Chairman Volcker expressed his gratification at the stated intention by Congress to achieve greater fiscal restraint but went on to observe that considerably more remains to be done in this area. Even after allowance for the effect of recession on lowered revenues on the one hand and increased expenditures on the other, the achievement of the objectives of the Budget Resolution still implies a deficit in fiscal year 83 as large as that in the current year. He questioned, in other words, whether

BEST DOCUMENT AVAILABLE

the premise of increased fiscal responsibility has as yet been achieved. We cannot disagree with this observation.

On the assumption, however, that this budgetary objective is achieved and to the extent that this leads to diminished concern about future financing volumes by the Treasury, reduced crowding out of private borrowers, and lowered fears of inflation, Chairman Volcker states:

> I believe as a practical matter a firmer budgetary posture might permit a degree of greater flexibility in the actual short-term execution of monetary policy without arousing inflationary fears.

However, he went on to caution:

> . . .the Committee did not feel that the budgetary effort, important as it is, would in itself appropriately justify still greater growth in the monetary aggregates over time than I have anticipated. Indeed, excessive monetary growth—and perceptions thereof—would undercut any benefits from the budgetary effort with respect to inflationary expectations. We believe fiscal restraint should be viewed more as an important complement to appropriately disciplined monetary policy than as a substitute.

Underlying the Federal Reserve Board Chairman's statement, therefore, is the thesis that interest rates—particularly long rates—are driven principally by deficits that many fear will ultimately be monetized through aggressive expansion of the money supply by the Federal Reserve, thus reigniting inflation. There are those, however, who favor just such a course for stimulating economic recovery, arguing that the present slack in the economy makes immediate inflationary consequences unlikely. Later on—the argument goes—possible inflationary tendencies can be dealt with by incomes policies, including guide posts, and wage and price controls. The latter course, it seems to us, is a counsel of desperation. We have tried these measures, and they have been found wanting. Given the prevailing psychology of the money markets, we see no alternative to the Federal Reserve's strategy of nurturing its credibility through moderate monetary expansion coupled with flexibility in responding to specific market requirements and as budgetary conditions permit.

Conclusions

Chairman Volcker opened his statement to the Committee with this observation:

> . . . by the late 1970's, that (inflationary) trend had shown every sign of feeding upon itself and tending to accelerate to the point where it threatened to undermine the foundations of our economy.

We have made considerable progress toward reversing that trend: inflation by any measure has fallen decisively during the last year. It would be tragic to abandon the set course that has gained us so much headway in reducing inflation and in lowering interest rates.

BEST DOCUMENT AVAILABLE

Flexible money management—combined with responsible budget making by Congress—will enable us to provide the ambient conditions to permit an early and complete economic recovery. The signs are increasing that this is indeed taking place.

BILL STANTON,
CHALMERS WYLIE,
STEWART MCKINNEY,
GEORGE HANSEN,
TOM EVANS,
NORMAN D. SHUMWAY,
ED WEBER,
BILL MCCOLLUM,
G. C. WORTLEY,
MARGE ROUKEMA,
BILL LOWERY,
JAMES COYNE,
DAVID DREIER,

BEST DOCUMENT AVAILABLE

DISSENTING VIEWS OF HON. RON PAUL ON MONETARY POLICY

For the eighth time the Committee is engaged in its semiannual report on monetary policy. While the economy disintegrates, the money manipulators in the Federal Reserve and the Banking Committee disagree about a 1½-percent change in the growth rate of M_1, a fictitious statistic whose relationship to money is purely coincidental. The Committee has never questioned—and perhaps will never question, unitl it is too late—the assumptions that the government can control the monetary system and ought to control the monetary system. All it does is quibble about statistics that mean little, if anything. What difference does it make that the FED is going to increase M_1 at 5½ percent rather than 4 percent without simultaneously shifting target ranges? Who knows what the proper target range is? Who knows whether there is a proper range? (Who can know?) Isn't it a tad ludicrous to think that 12 men sitting around an oval table can decide what the proper money supply is for a nation with a G.N.P. of three trillion dollars and a population of 230 million? Superstitions die hard, and the superstition of central monetary planning is one of the most persistent. Unitl we are ready to challenge and discard that superstition, we ought to be prepared for chronic monetary crises of increasing serverity.

Central economic planning is the driving superstition of socialism, fascism, and Naziism, and central banking has been a persistent superstition plaguing free societies. There is abundant evidence that central economic planning does not and cannot work; the perennial crop failures, industrial slumps, and shortages that characterize socialist nations ought to convince anyone not idologically committed to statism.

Scholars are now assembling the evidence that central banking is equally worthless. In this country we not only have the examples of the National Banks in the 19th century, but the unparalleled devastation caused by the Federal Reserve System in the 20th century. For 70 years, the Federal Reserve has caused, contributed to, or exacerbated the greatest depressions, recessions, panics, and inflations in our history. It is only the grip that the superstition of central banking has on our minds that can explain our blindness to the role of central banking in destabilizing our economy.

In their seminal work, A Monetary History of the United States, 1867–1960, Freidman and Schwartz write:

> The contraction from 1929 to 1933 was by far the most severe business-cycle contraction during the near-century of U.S. history we cover and it may well have the most severe in the whole of U.S. history. . . . At it was, the existence of the Reserve System prevented concerted restriction [of convertibility of deposits into currency], both di-

BEST DOCUMENT AVAILABLE

rectly and indirectly. . . . The result was that the episode, instead of being the climactic phase of the banking difficulties, was only the first of a series of liquidity crises that was to characterize the rest of the contraction. . . .

In his history of the depression, Dr. Murray Rothbard writes:

> Instead of preventing inflation by prohibiting fractional-reserve banking as fraudulent, governments have uniformly moved in the opposite direction and have step-by-step removed these free-market checks to bank credit expansion, at the same time putting themselves in a position to direct the inflation. In various ways, they have artificially bolstered public confidence in the banks, encouraged public use of paper and deposits instead of gold [finally outlawing gold], and shepherded all the banks under one roof as that they can all expand together. The main device for accomplishing these aims has been Central Banking, an institution which America finally acquired as the Federal Reserve System in 1913. . . . Given the Federal Reserve System and its absolute power over the nation's money, the federal government, since 1913, must bear the complete responsibility for any inflation. The banks cannot inflate on their own; any credit expansion can only take place with the support and acquiescence of the federal government and its Federal Reserve authoritites.

If the Committee is serious about dealing with our present economic difficulties, it must remove the ideological blinders that prevent it from seeing the role that the FED has played in causing those difficulties. Nitpicking about target ranges is tantamount to polishing the rail on the Titanic. What we must do is change the system, not the targets. My full views on this matter are contained in the newly released, The Case for Gold, and I commend it to the study of the Committee.

O